BEFORE THE NEBRASKA PUBLIC SERVICE COMMISSION

In the Matter of the Nebraska Public Service Commission, on its own motion, seeking to investigate the use of expense caps in the earnings calculation for Nebraska universal service fund support.	Application No. NUSF-64

COMMENTS OF UNITED TELEPHONE COMPANY OF THE WEST d/b/a EMBARQ

United Telephone Company of the West d/b/a Embarq respectfully submits these comments in response to the issues set forth in the Commission's order in the above referenced docket, entered on March 6, 2007.

INTRODUCTION AND BACKGROUND

On December 19, 2006, the Commission opened this docket to investigate the use of expense caps in the earnings calculation for the receipt of Nebraska universal service fund ("NUSF") support. The Commission is considering placing caps on certain operational expenses as reported on the NUSF-EARN form, which Nebraska eligible telecommunications carriers ("NETCs") must file annually. The NUSF-EARN form is used by the Commission to determine a company's need for support. The Commission held a public workshop on January 31, 2007 to obtain input from interested parties on how the proposal should be developed and any standards that should be included in the expense cap formula.

The Commission has not, either in its order opening this docket or in this Order Seeking Comments, articulated its reasons or goals for establishing and implementing expense caps, let alone established sufficient record support to justify adoption of an expense cap.[1] For example, it is unclear to Embarq whether the Commission plans to use the expense caps as a substitute for the existing 12% earnings cap on the NUSF-EARN form or if the expense caps will be yet another hurdle NETCs must clear to show need for support. Additionally, the, parties need to know if the proposed expense caps will be structured and implemented in such a way to provide incentives to NETCs to make efficient investments in their networks. Without a clear understanding of these issues and the Commission's rationale for its proposal, it is difficult for Embarq to provide relevant comments but, generally, Embarq believes that expense caps are not needed as expenses for which NETCs may receive support are already limited and it will create a disincentive for NETCs to invest.

EXPENSE CAPS ARE NOT NEEDED AND WILL CREATE A DISINCENTIVE TO INVEST

The Support Allocation Methodology ("SAM") established by this Commission in NUSF-26 utilized forward looking economic costs to determine loop costs. Those forward looking costs include defined expense levels. Due to limitations on the fund size, the NUSF does not distribute all the support NUSF recipients require, as calculated by the SAM. Between the use of forward looking loop costs in the SAM and the limit on the NUSF distributions, the expenses for which NETCs may receive support are already limited. Therefore, expense caps are not needed.

Limiting the level of expenses that may be shown on the NUSF-EARN form amounts to *de facto* rate-of-return regulation, similar to the use of the 12% earnings cap. Although the Commission would not be approving the rates NETCs may charge, expense

[1] Nor has the Commission shown how imposition of an expense cap will result in support that is "specific, predictable, sufficient" and "sufficient to achieve the purpose of the act" when it creates the concerns articulated herein, including a disincentive to invest. Neb. Rev. Stat. §86-323(5) and §86-324(l).

caps and earnings caps allow the Commission to determine "appropriate" levels of expenses and earnings. This process is very similar to that of a rate case, with the difference being that instead of determining how much revenue a company may receive from rates, the Commission is determining how much support a company is eligible to receive from the NUSF.

Embarq believes that the Commission's practice of using the 12% earnings cap to determine a company's need for support does not provide an incentive to all NETCs to invest in their networks. Underlying the Commission's practice of using an earnings cap is the assumption that, as a company invests, rate base will increase and therefore the "allowable" earnings will also increase. However, not all additional investment translates into additional NUSF support. An NETC will receive additional NUSF support only if the additional investment results in the NETC's earnings falling below the 12 % earnings cap. In Docket C-1628, the Commission stated:

> Rate of return adjustments will be made in the following manner. The actual support for an [eligible carrier] with a rate of return no greater than 12 percent over the test period will equal its total eligible support. For [eligible carriers] earning a rate of return greater than 12 percent over the test period, actual support will be the total eligible support less the reduction in revenue required to lower the rate of return over the test period to 12 percent.[2]

In NUSF-26, the Commission continued the use of "an earnings test to determine that NUSF support does not exceed the level required by NETC's to recover their costs."[3] In NUSF-26, the Commission also created the Over Earnings Redistribution ("OER").

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[2] *In the Matter of the Application of the Nebraska Public Service Commission, on its own motion, seeking to conduct an investigation into intrastate access charge reform,* Application No. C-1628, Findings and Conclusions entered January 13, 1999, page 7.
[3] *In the Matter of the Nebraska Public Service Commission, on its own motion, seeking to establish a long-term universal service funding mechanism,* Application No. NUSF-26, Findings and Conclusions entered November 3, 2004, para. 61.

The OER distributes NUSF support that becomes available when one or more NETCs earn above the 12% earnings cap. In establishing the OER, the Commission stated:

> As companies invest additional monies into their networks, those at or above the earnings cap will see a decrease in their respective rate-of-return. As such, additional SAM support amounts will begin to flow back to those companies. Thus, as a company invests and stakes claim to its SAM support amounts, OER monies available will gradually decrease.[4]

An NETC's support is determined by the SAM, not the NUSF-EARN form. The NUSF-EARN form illustrates the company's *need* for support, with support being phased out if the NETC earns above the 12% earnings cap. Upon information and belief, approximately ten (out of 38) NETCs currently have a rate of return that exceeds the 12% earnings cap. Only those ten NETCs may see any potential additional NUSF support from additional investment at this time. The other 28 NETCs likely would not receive any additional NUSF support from investing in their networks. In addition, any investment that may have the effect of reducing expenses, and therefore increasing earnings above the 12% earnings cap, may not be undertaken if there is the possibility of losing NUSF support. The Commission's perceived incentives to invest simply do not exist for most NETCs.

Unless structured appropriately, expense caps on the NUSF-EARN form similarly may create a disincentive for companies to make efficient investments in their networks. Companies should be allowed to keep existing NUSF support if their actual expenses come in below the established expense cap, especially if those reduced expenses results in the company exceeding the 12% earnings cap. Presumably, an NETC's draw from the NUSF fund may be reduced if its expenses exceed the cap established by the

[4] Ibid, para. 75.

Commission. Therefore, a company may choose not to invest in its network if that investment has the potential of increasing expenses and decreasing NUSF support. Any expense caps implemented by the Commission should work both ways: if the expense caps punish those companies that exceed the expense cap by reducing NUSF support, the expense caps should also reward companies that make efficient investment by allowing those companies to keep (or possibly increase) existing NUSF support.

If the Commission implements expense caps as an additional test that NETCs must pass to receive support, those expense caps will create additional complexity for NETCs in making business decisions. An NETC must take into consideration all relevant information when evaluating business cases and making business decisions, including the impact those decisions may have on NUSF distributions. NETCs will face a two pronged test in making those decisions: 1) will the investment cause expenses to increase above the Commission established expense caps, possibly causing a reduction in NUSF support; and 2) will the investment cause earnings to increase above the 12% earnings cap, causing a reduction in NUSF support. This problem represents a no-win situation for NETCs and will not create an incentive to make efficient investments. Investment decisions will be significantly more complicated, requiring additional time for evaluation and decision making. The additional scrutiny that potential projects would go through may delay or impede the provision of new services to customers or negatively impact the quality of service.

COMMISSION QUESTIONS

On March 6, 2007, the Commission requested comments on five questions regarding the possible implementation of expense caps. Embarq answers are set forth below to the Commission questions:

1. How will or should implementation of expense caps be administered through the NUSF-EARN Form process?

The question of how to administer the expense caps in the NUSF-EARN form process is premature. The Commission must first determine if expense caps are needed and then it must determine the appropriate methodology to calculate them. The calculation and administration of the expense caps would differ depending on whether the expense caps would be a *substitute for* or *in addition to* the existing 12% earnings cap. Until the questions of the appropriateness, use, and calculation of expense caps are answered, Embarq cannot make any recommendations regarding the implementation of expense caps except to indicate serious concerns with the incentives or disincentives it may create as raised above. However, should the Commission decide to implement expense caps on the NUSF-EARN form, it should ensure that the expense caps are structured to allow companies that make efficient investments in their networks to retain existing NUSF support.

2. In the event that an expense cap proposal were to be implemented, should such proposal be restricted only to prospective application, and should a transition period be implemented?

Under any circumstance, any such cap must be applied only on a prospective basis. In making business plans and decisions, NETCs must consider all relevant information, including anything that may impact distributions from the NUSF. It would be inappropriate for the Commission to apply the caps retroactively, because companies have not had an opportunity to adjust business plans and decisions for those expense caps that may impact distributions from the NUSF.

In addition, the expense caps should be calculated and communicated to NETCs prior to the beginning of the calendar year in which the expense caps would be used. For instance, if expense caps were to be used for the NUSF-EARN form for the 2008 calendar year, those caps must be calculated and communicated to the NETCs prior to the beginning of 2008 with sufficient time to allow companies to adequately react and adjust business plans in advance of adoption. As stated, NETCs will need the expense cap information in order to make informed operational business decisions for the year. Not providing the expense cap information until after the year has begun or, worse, after the year is over, would unfairly penalize NETCs for something that is beyond their control, but entirely within the control of the Commission.

3. Should expense cap calculations be subject to adjustments or waiver based upon company-specific expense characteristics such as low population density, high service costs or unusually costly projects undertaken to improve service? What should be the process for making these adjustments?

The Commission should ensure that any expense cap calculations are adjusted for company-specific characteristics. Without additional guidance from the Commission regarding the goals of the expense caps, it is not possible to say exactly what company-specific characteristics should be considered or the process for making those adjustments. However, there are many variables that impact a company's cost structure: urban versus rural, population density, number of access lines, ratio of in-town versus out-of-town access lines, level and type of competition, and route miles, just to name a few. In addition, telecommunications is a business characterized by extremely high fixed costs; therefore changes in any of the variables may not necessarily cause an immediate commensurate change in the level of expenses incurred. No two companies will have the same cost structure. It would be inappropriate for the Commission to model costs, and establish expense caps, without taking into account all of the different variables that impact costs.

Similarly, a process should be implemented to allow for increased expense caps when companies undertake potentially costly projects to improve service. Not doing so may incent companies not to initiate any projects that would cause their expenses to exceed the expense limitations, and may potentially delay the provision of new services to consumers or negatively impact the quality of service.

4. The Commission proposes including expense categories 6110, 6120, 6220, 6230, 6310, 6410, 6510, 6610, 6620, 6710 and 6720. Interested parties should comment on whether the foregoing list of expense categories is appropriate to use. If not, interested parties should elaborate on the reasons for exclusion of certain expense categories.

Embarq does not believe expense caps should be implemented for any of the expense categories listed. Each of these expense categories is a valid expense for the maintenance, provision, and upgrade of service for which high-cost support is intended. These expenses appropriately can be recovered through the NUSF high-cost fund and there should not be any limits placed on those expenses for the determination of support need. As previously mentioned, expenses for which NETCs may receive support have already been limited, as a result of the SAM and the limits on NUSF distributions.

However, should the Commission determine that limiting the amount of expenses that can be shown on the NUSF-EARN form is appropriate, Embarq recommends that expense caps be calculated for only expense categories 6710 (Executive and Planning) and 6720 (General Administration). As the account names suggest, the expenses in these two categories have an indirect, rather than a direct, impact on the maintenance, provision, and upgrading of service. These expense categories deal more with general oversight functions, such as Accounting, Legal, and Human Resources. All of the other expense categories listed have a direct impact on service and should not be limited when calculating a company's support needs. Establishing expense caps for expense categories other than 6710 and 6720 may impact the quality of service provided to customers. As labor and benefits make up a large portion of expenses, establishing expense caps on the expense categories other than 6710 and 6720 may lead to a reduction in the number of service technicians in the field and negatively impact the quality of service customers receive.

FCC accounting rules require the proper classification of expenses into one of the four major expense groups: Plant Specific Operations, Plant Nonspecific Operations, Customer Operations, and Corporate Operations. The FCC rules explicitly lay out the types of expenses that are to be recorded in each of the major expense groups. As a result, companies have little discretion to reclassify expenses into another expense category. Therefore, if the Commission establishes expense caps only for certain expense categories, companies will be unable to shift expenses to an expense category that may not subject to expense caps in an attempt to avoid exceeding the cap and losing NUSF support.

5. Should the proposal to establish expense caps contain different terms and conditions applicable to rural and non-rural NETCs?

Embarq is unsure what the Commission means when it refers to "terms and conditions." Terms and conditions may refer to the rules which NETCs must follow as they pertain to expense caps and NUSF support. Terms and conditions may also refer to the model that will be used to calculate and implement the expense caps. Additional information is needed from the Commission before Embarq can provide any substantive comments to this question. If the Commission means the model that will be used to calculate and implement expense caps, there are many variables that impact a company's cost structure, with rural or non-rural being just one of those variables. A small, rural NETC with a few thousand access lines will experience a dramatically different cost structure than a large, non-rural NETC with several hundred thousand access lines. Every effort should be made by the Commission to create a model that will account for these many different variables in establishing the expense caps and also in determining the terms and conditions applicable to each NETC.

CONCLUSION

Embarq does not believe that the Commission should establish expense caps to be used on the NUSF-EARN form. Embarq believes that implementing an expense cap proposal at this stage is premature because the Commission has not provided sufficient rationale or justification on the record for why an additional expense cap is necessary. In contrast, the record clearly shows that expenses used for the calculation of NUSF support are already limited due to the SAM and the limits on NUSF distributions so additional controls are not needed. In fact, the record shows that expense caps, similar to earnings caps, may create a disincentive for NETCs to make efficient investment in their networks, harming universal service. Clearly if the Commission decides that it should establish and implement expense caps, it should do so in such a way that would allow companies that make efficient investment in their networks and report expenses below the established caps to maintain or increase their NUSF support. Furthermore, if expense caps are established, the Commission should only establish caps for expense categories 6710 and 6720. All other expense categories directly impact the maintenance, provision, and upgrading of service and caps on these categories may affect the quality of service Nebraska consumers receive.

Respectfully submitted this 6th day of April, 2007,

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